2

No. 91-612

In the Supreme Court of the United States

OCTOBER TERM, 1991

HOWARD GILMAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

JONATHAN S. COHEN
STEVEN W. PARKS
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTIONS PRESENTED

1. Whether petitioner's purchase and leaseback of computer equipment in a transaction designed to produce only tax benefits was a sham, with the result that petitioner is not entitled to income tax deductions claimed in connection with the transaction.

2. Whether petitioner was subject to a valuation overstatement penalty under Section 6659(c) of the Internal Revenue Code (26 U.S.C.), based on his claim of a tax basis in the computer property that was more than 150 percent of his correct basis ($3 million, compared to zero).

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-642

HOWARD GILMAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 933 F.2d 143. The opinion of the United States Tax Court (Pet. App. 22a-43a) and the Tax Court's supplemental opinion denying petitioner's motion to vacate or revise the opinion (Pet. App. 45a-48a) are reported at 58 T.C.M. (CCH) 1075 and 59 T.C.M. (CCH) 465.

JURISDICTION

The judgment of the court of appeals (Pet. App. 54a-55a) was entered on May 14, 1991. The petition for rehearing was denied on July 16, 1991 (Pet. App. 53a). The petition for a writ of certiorari was timely filed on October 15, 1991, October 14, 1991, being a

holiday. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In November of 1980, petitioner was solicited to participate in a sale and leaseback of computer equipment (Pet. App. 2a, 23a, 30a). The computer equipment offered to petitioner was owned by Disko Leasing GmbH (Disko), a West German company that had leased the equipment to end-users in Europe under leases that expired between mid-1982 and early 1985 (*id.* at 2a-3a, 23a). Disko had originally paid $4.1 million for the equipment, which it had financed by a loan from its parent company (*id.* at 3a).

Petitioner agreed to proceed with a transaction structured as follows (Pet. App. 24a-25a): On December 30, 1980, Disko sold the computer equipment to Equilease B.V. (Equilease), a Netherlands corporation, for $2.7 million, subject to the leases and the security interests that secured Disko's financing of the equipment (*id.* at 3a, 24a). On the same day, Disko leased the equipment back from Equilease for a term of nine years. On December 31, 1980, Equilease sold its interest in the computer equipment to Aardan Leasing Corporation (Aardan) for $2.99 million (*id.* at 3a & n.1, 25a). On the same day, Aardan transferred that interest to petitioner for $3 million (*id.* at 3a, 25a). Petitioner then leased the equipment back to Equilease for a term of nine years, and Equilease assumed responsibility for maintenance, repairs, taxes and insurance (*id.* at 3a, 26a).[1] Under

[1] According to the promoter, Aardan was inserted into the transaction in an effort to comply with the "at risk" provisions of Section 465 of the Internal Revenue Code (Pet. App. 3a n.1).

this lease, Equilease was to receive ten percent of any residual value of the equipment (*id.* at 34a).

Petitioner paid Aardan $45,000 in cash and gave Aardan an interest-bearing promissory note in the principal amount of $2,955,000 (Pet. App. 3a, 26a).[2] Petitioner also gave Aardan promissory notes (which themselves bore interest) for the amount of interest due in 1981 and 1982 (*id.* at 4a, 26a). Petitioner's total cash investment in the equipment was $469,597, consisting of his $45,000 initial payment, and payments under two short-term notes totaling $424,597 (*id.* at 3a-4a, 27a). Petitioner was to recover all of those payments, plus considerably more, through claimed tax benefits from the transaction, in the form of depreciation and interest deductions on the deferred payments (*id.* at 27a). Thereafter, from 1983 through 1989, petitioner was to make monthly payments under the note to Aardan, in the amount of $65,619.32. During that same period, Equilease was to make offsetting monthly rental payments to petitioner of $66,319.32, a difference of $8,400 per year (*id.* at 4a, 26a).

In order for petitioner to receive any economic profit from the transaction (apart from its tax benefits), the salvage value of the equipment at the end of his nine-year lease with Equilease would have to ex-

---

[2] In form, almost $2 million of the $2,955,000 promissory note was recourse (Pet. App. 3a-4a). Petitioner, however, also had the option of deferring payment on the note for up to 14 years if Equilease failed to make its lease payments. His note was secured by the equipment and its rental income, and, as discussed above, from 1983 through 1989, the monthly rental payments petitioner was scheduled to receive from Equilease closely paralleled the purchase payments he was obligated to make to Aardan (*id.* at 3a-4a, 26a).

ceed $437,774, or 14.6 percent of the original purchase price (Pet. App. 8a, 34a).[3] At the end of petitioner's lease, however, it was foreseeable that the equipment would be on the verge of obsolescence (*id.* at 36a) and that its scrap value would be far less than ten percent of petitioner's cost (*id.* at 37a). Petitioner had given no consideration to the salvage value of the equipment because he was interested only in obtaining tax benefits (*id.* at 12a, 30a-33a). Petitioner had not obtained an appraisal of the value of the equipment or of its estimated salvage value (*id.* at 12a, 30a-31a).[4]

2. On his tax returns for 1980 and 1981, petitioner claimed substantial deductions from the purported computer equipment leasing transaction. The Commissioner of Internal Revenue determined, however, that the transaction was devoid of economic substance and that petitioner therefore was not entitled to the claimed deductions (C.A. App. 17; Pet. App. 23a).[5] As a result, the Commissioner determined

---

[3] The figure of $437,774 reflects a net investment by petitioner of $393,997 ($469,597, less nine periodic payments of $8,400), divided by .9 (petitioner was entitled to only 90 percent of any salvage value) (Pet. App. 8a, 34a).

[4] Petitioner asserts that he obtained "[a] contemporaneous appraisal" (Pet. 4) that supported the $3 million purchase price. But that claim was rejected by the Tax Court in factual findings that were sustained by the court of appeals (Pet. App. 6a-7a, 27a, 30a-31a).

[5] The Commissioner also determined that the deductions claimed by petitioner were not allowable because petitioner had not engaged in the transaction with the requisite profit motive (see 26 U.S.C. 183), because he was not "at risk" with respect to his indebtedness (see 26 U.S.C. 465) and because he had used an inappropriate method of depreciation (Pet. App. 22a-23a).

that petitioner was liable for income tax deficiencies for his 1980 and 1981 taxable years of $171,680 and $329,555, an addition to tax attributable to a valuation overstatement under Section 6659 of the Internal Revenue Code (26 U.S.C.) of $98,867 for his 1981 taxable year,[6] and interest on both the 1980 and 1981 tax deficiencies at the penalty rate of 120 percent of the ordinary rate under Section 6621(c) (Pet. App. 4a-5a, 22a-23a). Petitioner sought a redetermination of the deficiencies in the Tax Court.

3. The Tax Court found that the transaction was an economic sham that petitioner had entered into with "no[] * * * business purpose other than obtaining tax benefits" (Pet. App. 30a, 33a).[7] Since petitioner failed to demonstrate that "a prudent investor could have concluded" (*id.* at 34a) that at the termination of the lease the computer equipment "would have any measurable residual value" (*id.* at 41a), the court further found that the transaction was devoid of economic substance (*id.* at 34a-42a). As the Tax Court summarized the situation, petitioner's transaction "served no useful economic purpose" and reflected only "paper shuffling" among Equilease, Aardan and petitioner (*id.* at 42a).

The Tax Court also concluded that petitioner's correct adjusted basis in the property for the purpose of

---

[6] Section 6659 was enacted in 1981. It is applicable to tax returns filed after December 31, 1981. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722(a), 95 Stat. 341-343.

[7] Because the Tax Court found the transaction to be an economic sham, the court found it unnecessary to reach the question whether petitioner's claimed losses should be disallowed on any of the alternative grounds asserted by the Commissioner. See note 5, *supra*.

computing depreciation deductions was zero, rather than the $3 million he had claimed on his tax return (Pet. App. 43a). The Tax Court therefore held petitioner liable for an addition to tax (under Section 6659 of the Code) due to his overstatement of the depreciable basis of the computer equipment. In addition, the court concluded that petitioner was liable for interest on the tax deficiencies at the penalty rate of 120 percent of the ordinary rate, pursuant to Code Section 6621(c) (Pet. App. 43a).

In his motion to vacate the decision, petitioner argued that the overvaluation penalty in this case was inconsistent with *Todd* v. *Commissioner*, 89 T.C. 912 (1987), aff'd, 862 F.2d 540 (5th Cir. 1988), in which the Tax Court had held that depreciation deductions that were disallowed because the equipment had not been placed in service were not attributable to an overvaluation of the equipment (Pet. App. 48a). The Tax Court rejected that contention. Since petitioner's deductions had been denied because his transactions lacked economic substance, "section 6659 will apply because the correct basis is zero and any basis claimed in excess of that is a valuation overstatement" (*ibid.*).

4. The court of appeals affirmed (Pet. App. 1a-20a). A transaction is a sham, the court observed, "if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions" (Pet. App. 10a, quoting *Jacobson* v. *Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990)). The court sustained, as not clearly erroneous, the Tax Court's factual findings (i) that petitioner entered into the transaction with no business purpose other than obtaining tax benefits and (ii) that the transaction lacked economic substance (Pet. App. 11a-13a). Rejecting petitioner's contention that Section 6659 is in-

applicable to underpayments in tax that result from transactions found to lack economic substance, the court concluded that "[w]here a transaction is not respected for lack of economic substance, the resulting underpayment is attributable to the implicit overvaluation" (Pet. App. 19a).

ARGUMENT

1. The court of appeals correctly affirmed the Tax Court's factual conclusion that petitioner's computer leasing transaction was a sham. The central inquiry in determining whether a transaction is a sham is whether "there [i]s nothing of substance to be realized * * * from th[e] transaction beyond a tax deduction." *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960); see also *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935); *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 573 (1978). Consistent with that standard, the court of appeals defined a sham transaction as one that has "no business purpose or economic effect other than the creation of tax deductions" (Pet. App. 10a, quoting *Jacobson* v. *Commissioner*, 915 F.2d at 837).

It is apparent that petitioner entered into his computer leasing transaction with "no[] * * * business purpose other than obtaining tax benefits" (Pet. App. 12a, 30a, 33a). The possibility of achieving an economic profit in this case required the residual value of the equipment to exceed $437,774. But no investor could reasonably have concluded that the equipment would have "any" (*id.* at 41a) measurable residual value upon the termination of petitioner's leases (*id.* at 34a, 41a).[8] Petitioner ostensibly "purchased"

[8] Petitioner faults the Tax Court for failing to consider whether there was a "possibility" that he might make a "large

property from Aardan that Equilease had already leased to Disko for a term of nine years—essentially its entire economic life—and then "leased" it back to Equilease for a term of nine years, in a "paper shuffling" (*id.* at 42a) transaction that was designed to produce only "tax" profits in excess of petitioner's cash investment. The factual determinations of the

---

profit" (Pet. 16-17). But the Tax Court found that earning *any* profit depended on whether the residual value of the equipment would exceed $437,774 (Pet. App. 34a), that the equipment "would be on the verge of obsolescence" at the termination of petitioner's leases (*id.* at 36a), and that it would not have been reasonable to conclude that the equipment would have "any" measurable residual value upon termination of the leases (*id.* at 41a).

Moreover, petitioner's criticism is based on the notion that Section 183 of the Internal Revenue Code provides the governing standard for determining when a transaction is a sham. See Pet. 17-18. A sham transaction is one that is ignored for tax purposes because it is entered into only for tax benefits, and lacks economic substance. *E.g., Knetsch* v. *United States*, 364 U.S. at 366; *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935); *Rice's Toyota World* v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985). In contrast, Section 183 provides rules governing the allowability of deductions in non-sham activities that simply do not rise to the level of trades or businesses (Section 162), or activities designed to produce income (Section 212). See 26 U.S.C. 183(c); *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987) ("trade or business" requires that "the taxpayer's *primary* purpose for engaging in the activity must be for income or profit") (emphasis added); *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (same); *Bingham's Trust* v. *Commissioner*, 325 U.S. 365, 373-374 (1945) (predecessor provisions of Sections 162 and 212 are to be construed "*in pari materia*"); *United States* v. *Gilmore*, 372 U.S. 39, 45 (1963) (same). Consequently, petitioner's assertion that Section 183 should govern his case ignores the threshold issue whether his transaction should be recognized at all for federal tax purposes.

Tax Court have been sustained by the court of appeals (*id.* at 9a-13a) and do not warrant further review.

2. There is no merit to petitioner's contention (Pet. 16-24) that the decision of the court of appeals conflicts with the decisions of the Sixth Circuit in *Bryant* v. *Commissioner*, 928 F.2d 745 (1991) and *Smith* v. *Commissioner*, 937 F.2d 1089 (1991). The court stated in *Bryant* that the standard for determining whether a transaction is a sham is whether the transaction "has any *practicable* economic effects other than the creation of income tax losses," and that the taxpayer's "subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry." 928 F.2d at 748 (emphasis added) (quoting *Rose* v. *Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989)). Applying that standard, the court concluded that an ore mining operation in which the taxpayer had invested was a bona fide operating mine and was not a transaction in which the taxpayer had "merely purchased tax deductions." 928 F.2d at 749. In *Smith*, the transaction found to have "practicable [economic] effects other than the creation of income tax losses." (937 F.2d at 1096) was an experimental synthetic fuel process. The court concluded that the evidence in that case showed this to be "economically feasible" since there was "uncontradicted expert testimony stating that the * * * process did have a reasonable chance of generating profits." *Ibid.*

In the present case, the court of appeals defined a "sham transaction" as one that "has no business purpose or economic effect other than the creation of tax deductions" (Pet. App. 10a). This does not evidence any conflict with the standard articulated by the Sixth

Circuit in *Bryant* or *Smith*. As the court of appeals observed, in petioner's particular transaction, "the most important element for economic substance * * * was the residual value" of the equipment (Pet. App. 12a), which governed the possibility of earning *any* economic profit from the transaction. Since no reasonable person could have concluded that the equipment would have any residual value at the termination of the lease, however, petitioner's actual participation in the transaction was merely a matter of "paper shuffling" that added nothing to the existing economic relationships among the parties, apart from the purchase of tax benefits for petitioner (*id.* at 42a). Because the transaction was designed and intended by the parties to produce no economic consequences other than the creation of tax benefits for petitioner, the transaction qualifies as a sham under any standard (*id.* at 12a, 30a, 33a).

3. The court of appeals correctly held that imposition of the addition to tax under Section 6659 is appropriate when, as here, a tax deduction is disallowed on the specific ground that the transaction purportedly generating the deduction lacks economic substance.[9] See *Massengill* v. *Commissioner*, 876 F.2d

[9] Section 6659 imposes an addition to tax of up to 30 percent on any underpayment of tax that is attributable to a "valuation overstatement." 26 U.S.C. 6659. A "valuation overstatement" exists if the taxpayer reports on his tax return either a value or an adjusted basis for property that is 150 percent or more of the correct valuation or adjusted basis. 26 U.S.C. 6659(c). Section 6659 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to Section 6659 are now found in Section 6662(e), relating to substantial valuation misstatements. See 26 U.S.C. 6662(e) (Supp. I 1989).

616, 620 (8th Cir. 1989); *Rybak* v. *Commissioner*, 91 T.C. 524, 566-567 (1988); *Clayden* v. *Commissioner*, 90 T.C. 656, 677-678 (1988). Contrary to petitioner's contention, the decision of the court of appeals does not conflict with the decisions of the Fifth Circuit in *Todd* v. *Commissioner*, 862 F.2d 540 (1988), and *Heasley* v. *Commissioner*, 902 F.2d 380 (1990). Neither of those cases involved the disallowance of deductions from a transaction that lacked economic substance. Neither case thus presented the issue whether "[t]he lack of economic substance was due in part to the overvaluation, and thus the underpayment was attributable to the valuation overstatement" (Pet. App. 19a).[10]

In *Todd*, deductions were disallowed because the property at issue had not been "placed in service" during the taxable year. The Tax Court held (862 F.2d at 541), and the Fifth Circuit agreed (862 F.2d at 543), that the taxpayers' valuation of the property had "no impact whatsoever on the amount of tax actually owed" (*ibid.*). In the present case, the Tax Court distinguished its decision in *Todd* on the ground that *Todd* "did not address a situation such as in the instant case where the transaction lacked economic substance" (Pet. App. 48a). Because petitioner claimed a depreciable basis of $3,000,000 for

---

[10] It follows that petitioner's reliance (Pet. 9) on the "Blue Book" explanation of Section 6659, set forth in Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Act of 1981*, at 333 (1981), is unavailing. The explanation states that tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any "other" proper adjustments to tax liability. *Ibid.* In the present case, however, "[t]he lack of economic substance was due in part to the overvaluation, and thus the underpayment was attributable to the valuation overstatement" (Pet. App. 19a).

property obtained in a transaction lacking economic substance, he had overvalued the depreciable basis of that property. Since this overvaluation resulted in improper deductions, the overvaluation penalty was properly assessed. As the court concluded (*ibid.*), its analysis in this case is consistent with *Todd*, not in conflict with it.[11]

In *Heasley*, the Commissioner determined tax deficiencies on a number of alternative grounds, "including, among others, that petitioners did not have a profit objective, that the EMS units were not qualifying property, *that they were not placed in service*, and that the units were overvalued." *Heasley* v. *Commissioner*, 55 T.C.M. (CCH) 1748, 1754 (1988) (emphasis added). In the Tax Court, the taxpayers conceded that they were not entitled to the investment tax credits they had claimed, without stating any specific basis for their concession. They argued that, since they had conceded the deficiencies, "it is impossible to determine the reason for any understatement" (*ibid.*) and that they therefore were not liable for the addition to tax under Section 6659. The Fifth Circuit concluded that when a deduction or credit is disallowed in its entirety, the underpayment is not attributable to the valuation overstatement, but rather

---

[11] See also *McCrary* v. *Commissioner*, 92 T.C. 827 (1989), in which the Tax Court, following *Todd*, held that taxpayers who conceded prior to trial that they were not entitled to an investment tax credit on the ground that they had incorrectly characterized an agreement generating the investment tax credit as a lease (rather than as a license) were not liable for the addition to tax under Section 6659, but expressly cautioned "that a different situation exists" where a valuation overstatement or other tax-motivated transaction is instead "an integral part of or is inseparable from the ground found for disallowance of an item." 92 T.C. at 859.

"is attributable to claiming an improper deduction or credit." 902 F.2d at 383. Although that language is broad, *Heasley* did not involve a situation in which deductions were not allowed for the specific reason that the transaction lacked economic substance. The Fifth Circuit has not directly ruled whether application of the Section 6659 addition to tax would be warranted in that circumstance. There is thus no conflict in the decisions of the courts of appeals that would warrant further review.

4. The court of appeals held that the depreciable tax basis of property held as part of a sham transaction is zero. Petitioner claims that this conflicts with the reasoning of this Court in *Commissioner* v. *Acker*, 361 U.S. 87 (1959). Petitioner contends that, under *Acker*, he should be deemed to have "no" tax basis in his property, rather than a tax basis of zero (Pet. App. 13a-14a). Petitioner's contention is without merit. Even if his position were accepted, however, it would not relieve him of liability for the overvaluation penalty.

In *Acker*, the Court concluded that a taxpayer who fails to file a declaration of his estimated income tax liability should not be treated as having estimated his tax liability at zero for purposes of the penalty that applies to a substantial understatement of tax liability. See 361 U.S. at 91-94. In this case, however, petitioner was not "deemed" to have claimed a $3 million tax basis on his 1981 return; he *did* claim on the return that his correct tax basis for depreciation was $3 million. The Tax Court and the court of appeals correctly determined that petitioner's proper tax basis was zero. Under Sections 167(c), 1011 and 1012, a taxpayer's basis for computing depreciation deductions is his cost, and if a taxpayer's only "cost" is ignored because the transaction is a sham (Pet.

App. 17a), then his cost basis necessarily is zero. Petitioner's reliance on *Acker* is therefore misplaced. See *Rybak* v *Commissioner*, 91 T.C. at 566-567 (since master recording transactions were "devoid of economic substance" and were "to be disregarded for Federal income tax purposes," "petitioners' correct adjusted basis in the master recordings is zero"); *Rose* v. *Commissioner*, 88 T.C. 386, 426 (1987), aff'd, 868 F.2d 851, 853 (6th Cir. 1989); *Clayden* v. *Commissioner*, 90 T.C. at 677.

In any event, Section 6659 defines a valuation overstatement to occur when "the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct * * * adjusted basis." See note 9, *supra*. Since petitioner incorrectly claimed an adjusted basis of $3 million on his 1981 tax return, petitioner was liable for the Section 6659 penalty unless his correct tax basis was at least $2 million. Having "no" tax basis, as petitioner argues, would not give him a correct tax basis of at least $2 million.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

JONATHAN S. COHEN
STEVEN W. PARKS
Attorneys

DECEMBER 1991

☆ U. S. GOVERNMENT PRINTING OFFICE: 1991 312324 45201